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Central Intelligence Agency

Washington, D. C. 20505

DIRECTORATE OF INTELLIGENCE

28 November 1984

Japan: Export Reliance and Economic Growth [redacted] 25X1

Summary

Foreign demand--in particular exports to the United States--has provided the lion's share of Japan's recent economic growth, in sharp contrast to most other postwar Japanese recoveries. With foreign demand slowing, Tokyo is now looking to domestic demand to pick up the slack. In recent months the domestic sector has strengthened somewhat with increased investment spending, but consumption--which makes up over half of GNP--remains weak, and some analysts in Tokyo are concerned investment could decline when net exports drop off. Fiscal policy is constrained by the persistent budget deficit, leaving Tokyo in the short run with limited options to sustain growth. [redacted] 25X1

This memorandum was prepared by [redacted] Japan Branch, Northeast Asia Division, Office of East Asian Analysis. Information available as of 26 November was used in its preparation. Comments and queries are welcome and may be directed to the Chief, Japan Branch, Northeast Asia Division, OEA, [redacted] 25X1 25X1

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Foreign Demand

Foreign demand accounted for half of the increase in GNP in 1983,[1] the first year of the current recovery[2] (see figure 1), and net exports have continued to provide a substantial proportion of the economy's growth during the first half of 1984. The strong US demand for imports was a major factor in pushing export earnings to the fore. During the first year of the recovery Japan's trade surplus with the United States roughly doubled, from $3.1 billion in the first quarter of 1983 to $6.3 billion in the fourth quarter of 1983 (see figure 2). Exports to the United States during the year were up by $4.2 billion, while Japanese imports from the United States rose by only $1.0 billion. Sales to Asian NICs were also up, but the rising surplus with the United States accounted for 72 percent of the increase in Japan's trade surplus during the period. 25X1

The yen's persistent weakness, especially against the dollar, has been a major underlying reason for Japan's strong export growth. The exchange rate has aided Japanese exporters' competitiveness and profitability, especially in US markets. Forecasts for a substantial appreciation this year proved premature as capital outflows have continued to accelerate in response to interest rate differentials and prevented the current account surplus from driving the yen's rate up. 25X1

The strong performance of foreign demand in this recovery continues a trend that has been evident since the recession began in 1980. Net exports have accounted for half or more of GNP growth in three of the last four years (see figure 3). In previous postwar recoveries foreign demand never accounted for more than one third of GNP growth in any year, with the exception of the post-oil-shock years 1974 and 1975 (see figure 4). Indeed, the behavior of net exports during most of the postwar period was countercyclical--declining during expansions and increasing again during recessions. 25X1

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[1] Calendar years are used in this paper. 25X1

[2] Recessions and recoveries are determined by dates for peaks and troughs of business cycles published in the Economic Planning Agency's monthly "Japanese Economic Indicators." 25X1

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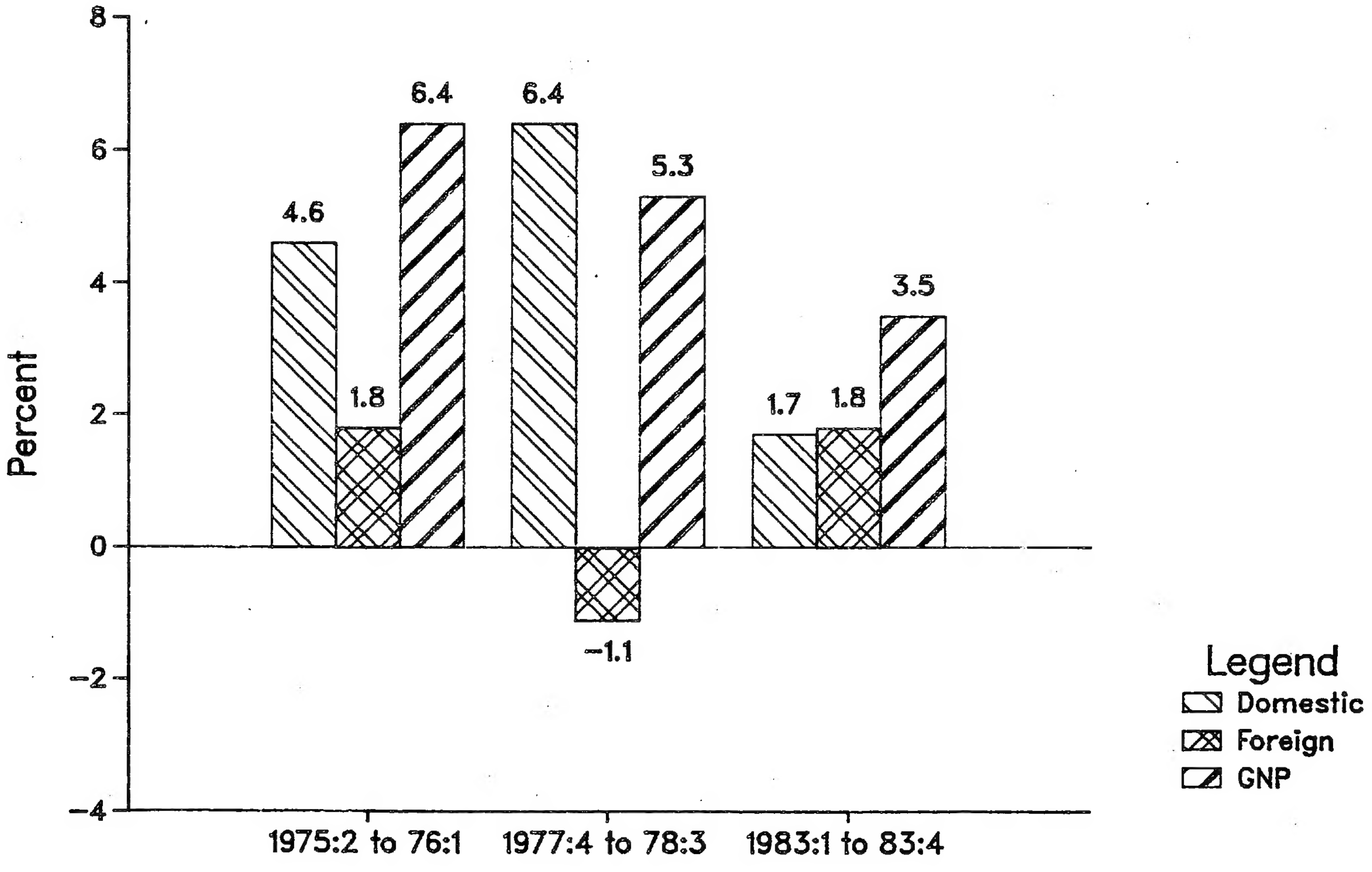
Figure 1

Growth in the First Year of Recovery Foreign and Domestic Components



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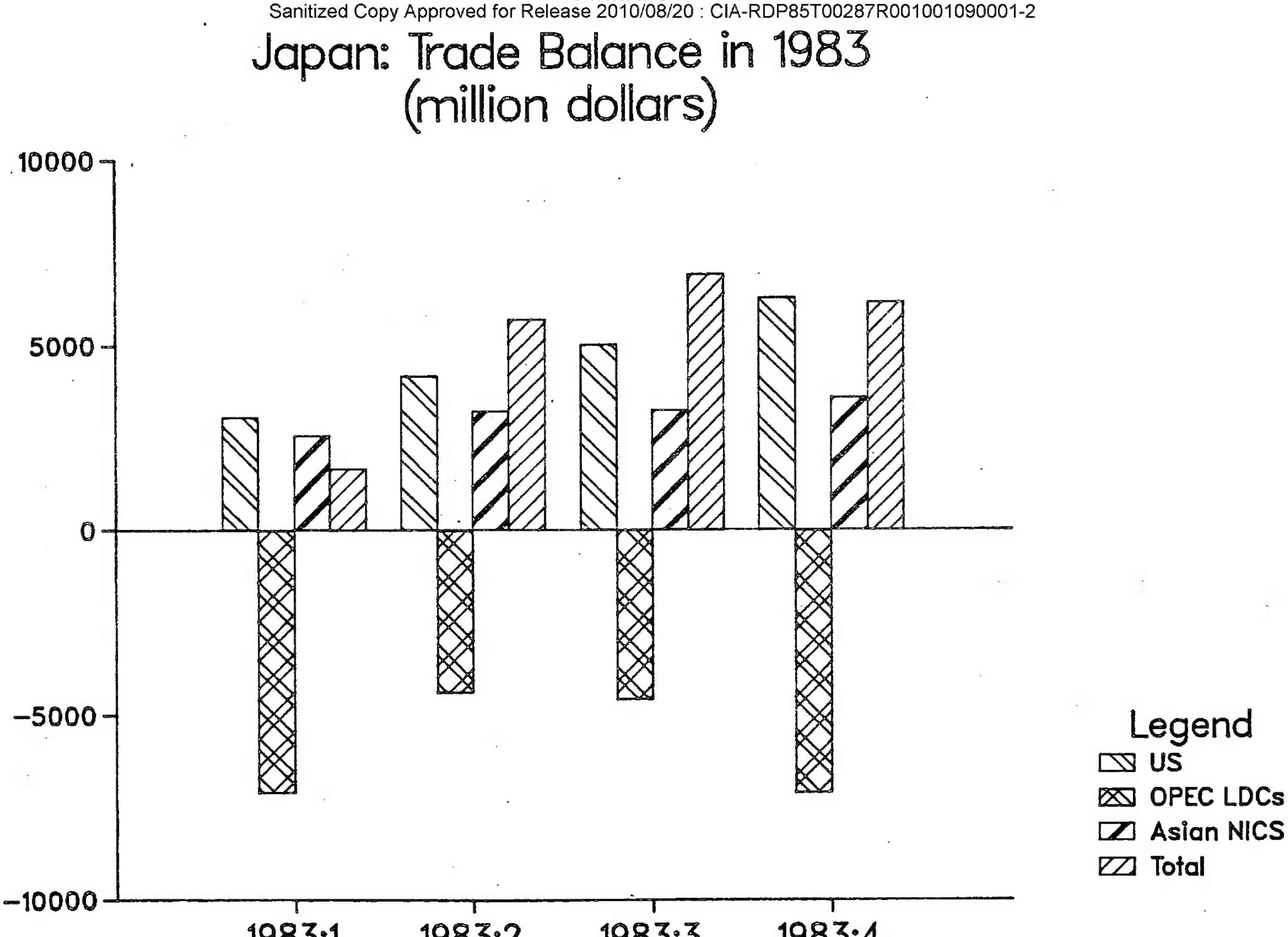
Last quarter over last recession quarter (percent).

Figure 2



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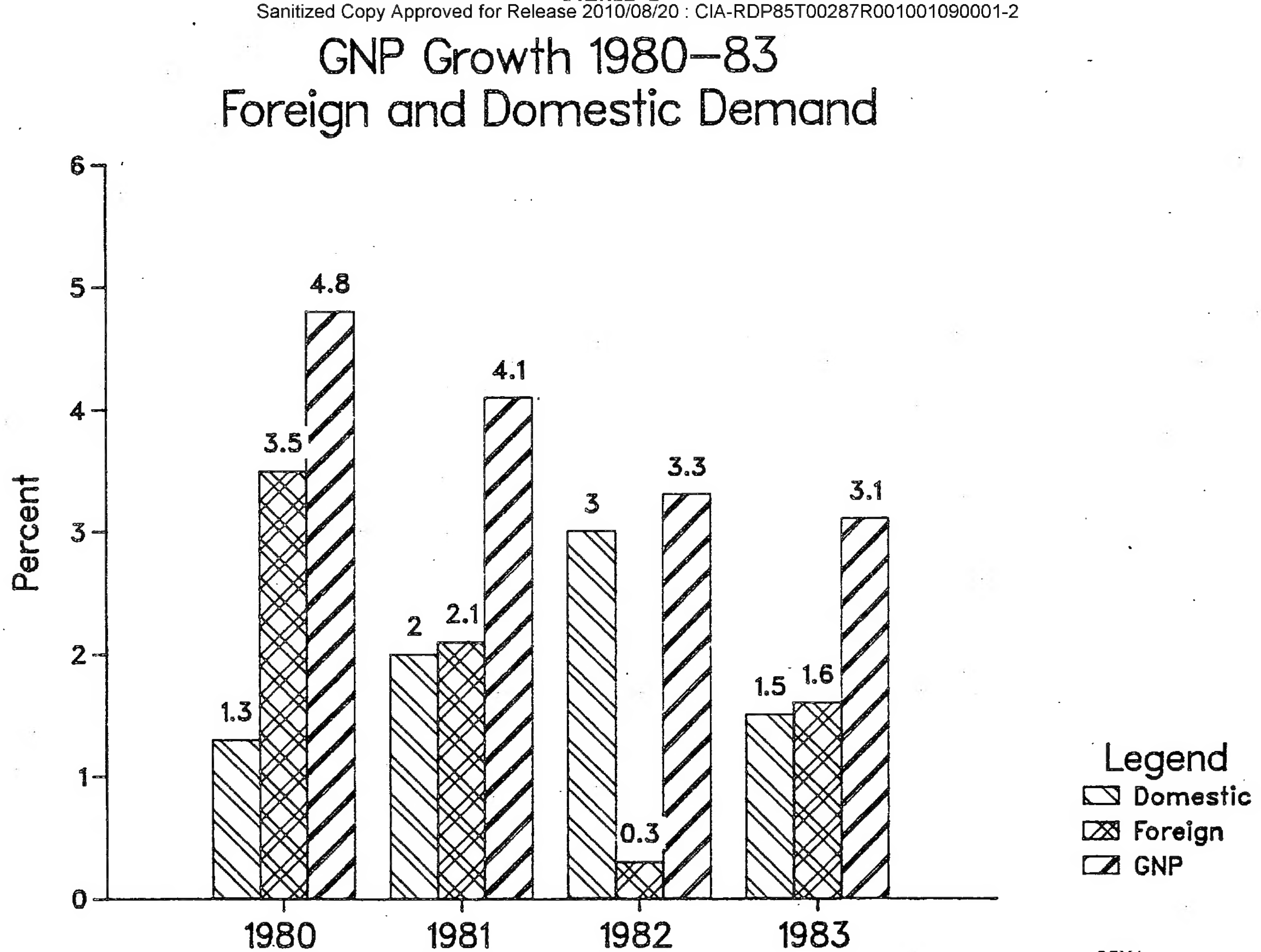

Calendar year average over previous year (percent).

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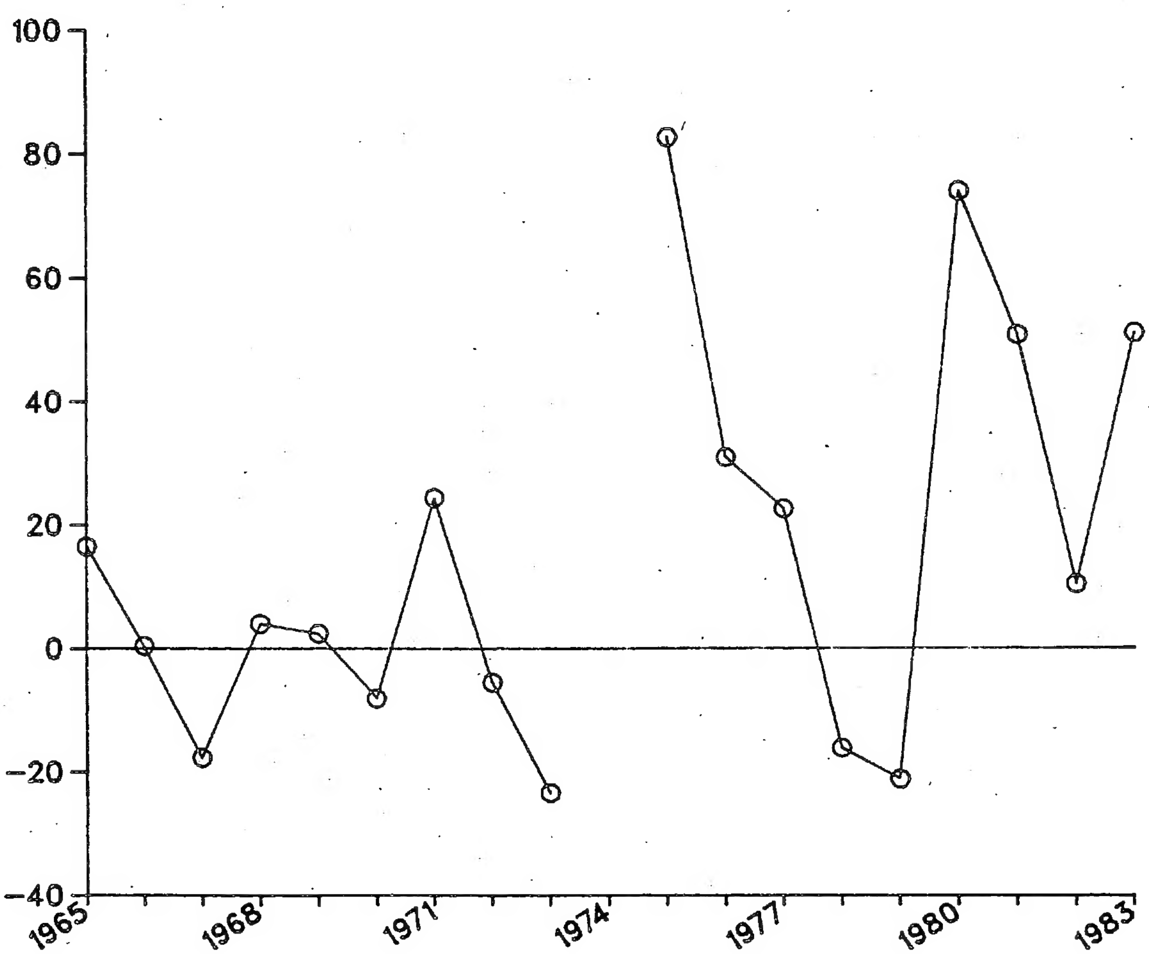
Figure 4

Foreign Demand as a Percentage of GNP Growth



Percent of total GNP growth.
1974 NOT computed because GNP growth was negative.

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Domestic Demand Slowing?

In the absence of much stimulus from government fiscal policy since 1979, the domestic component of growth has been very low by Japanese standards--averaging 2.0 percent per year in 1980-83, compared with annual averages of 4.6 percent in 1970-79 and 10.7 percent in 1960-69 (see figure 5 and Table 1). Private consumption demand is by far the largest potential domestic source of growth, accounting for over half of GNP. Despite an increase in real incomes, however, consumers have not provided much stimulus to growth in the current recovery. Indeed, during the first year of recovery private consumption increased more slowly than it had during the previous recession year. [redacted] 25X1

The weakness of consumption may be related to consumer uncertainty based on the labor market's continuing weakness and slow growth in real disposable incomes. Japanese observers expect consumer demand to pick up as the recovery proceeds. This expectation is based on a possible rise in disposable incomes later this year and next if strong corporate profits are reflected in higher year-end bonuses and larger real wage settlements next spring. [redacted] 25X1

Investment demand has generally been strong during this recovery, but this sector is smaller and typically more volatile than the consumption sector. Corporate fixed investment has increased rapidly, based on higher earnings and the prospect of more rapid growth in the near term. Housing investment, however, stagnated during the 1980 recession and has declined slightly since the beginning of the recovery. [redacted] 25X1

25X1 [redacted] companies plan to invest more during the coming year, but a debate is going on within the Economic Planning Agency (EPA) and elsewhere over whether the investment boom will continue once export growth slows. Those who are bullish argue that business cost-cutting and interest in continued technological improvement will fuel strong investment demand for some time to come. They point to surges of investment in industries such as pulp and paper as examples. Other economic observers, supporting the EPA's preference for fiscal stimulus, argue that most of the current pickup in investment is based on export-fueled demand. They insist that in the long run the changing structure of the economy will reduce the need for expenditures on new capital, as less capacity will be added in capital-intensive heavy industry. A slowdown in foreign demand would therefore cut short the investment boom, leaving the economy with no source of strong growth. [redacted] 25X1

The government's continuing efforts to reduce the persistent deficit mean fiscal stimulus will probably provide little to boost economic growth. Tokyo's policy could change, of course,

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Domestic Demand: Slowing Growth

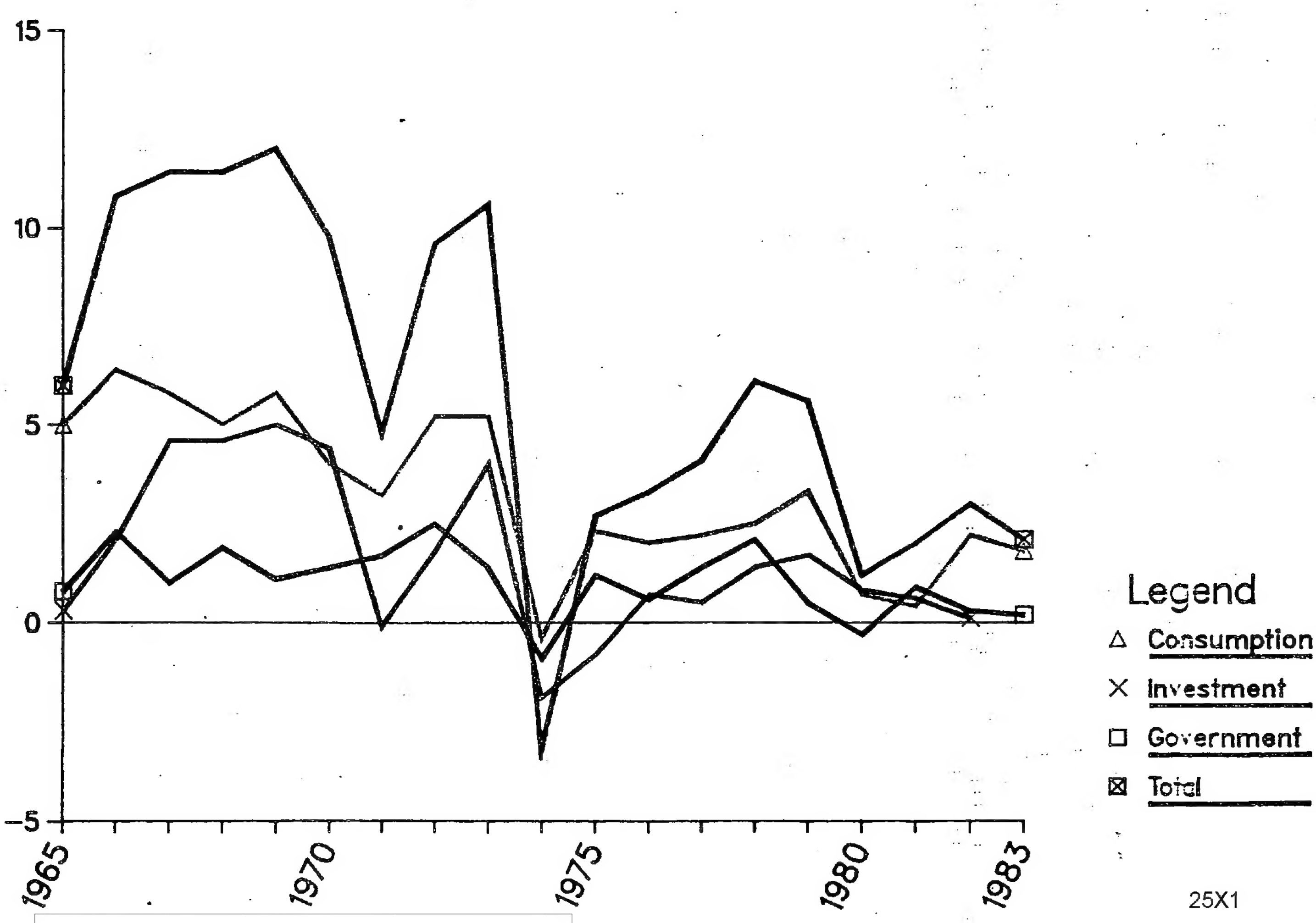

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Table 1

Sectoral Contributions to GNP Growth

	Total GNP	Net Exports	Domestic Demand (Total)	Consumption	Investment	Government Spending
1965	5.4	0.9	4.5	5.0	-1.3	0.8
1966	11.0	0.0	11.0	6.4	2.3	2.3
1967	10.7	-1.9	12.6	5.8	5.8	1.0
1968	12.7	0.5	12.2	4.9	5.3	1.9
1969	12.3	0.3	12.0	5.8	5.1	1.1
1970	10.0	-0.8	10.7	3.9	5.4	1.4
1971	4.7	1.1	3.6	3.2	-1.3	1.7
1972	8.9	-0.5	9.4	5.2	1.6	2.5
1973	8.9	-2.1	11.0	5.3	4.3	1.4
1974	-1.2	1.4	-2.6	-0.4	-1.3	-0.9
1975	2.4	2.0	0.4	2.3	-3.1	1.2
1976	5.3	1.6	3.7	1.9	1.1	0.6
1977	5.3	1.2	4.1	2.2	0.5	1.4
1978	5.1	-0.8	5.9	2.5	1.3	2.1
1979	5.2	-1.1	6.2	3.3	2.4	0.5
1980	4.8	3.5	1.3	0.7	0.8	-0.3
1981	4.1	2.1	2.0	0.4	0.8	0.9
1982	3.3	0.3	3.0	2.2	0.6	0.2
1983	3.1	1.6	1.5	1.8	-0.5	0.2

Note: Components may not add to total because of rounding.

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and some LDP politicians have argued for more fiscal stimulus, but we expect that any changes will be too small to help much. Indeed, the LDP's supporters in the business and financial world favor even tighter spending controls and a smaller government sector, as does the powerful Ministry of Finance, making a change in government commitment to fiscal austerity unlikely in the short term. [redacted] 25X1

When Export Growth Slows

Without stimulus from the foreign sector, it is difficult to see how Japan can sustain economic growth at the 4-percent level called for in most long-term forecasts and in the government's long-term economic "visions," let alone at the 5-percent rate called for by Prime Minister Nakasone's commission on the economy. If the growth rate of net exports should decline, domestic demand would have to do better than it has recently to maintain even the 3-percent GNP growth rates Japan achieved during the 1980-83 recession. [redacted] 25X1

Our own analysis, based in part on our econometric model, shows a significant decline in overall growth if foreign demand slows:

-- The baseline forecast calls for growth of 5.2 percent in 1984 and 4 percent in 1985 based on real merchandise export growth of 6.5 percent. If exports to the United States stopped increasing, however, growth would drop immediately. With exports to the United States held constant at the level of 1984's first quarter, the growth rates are 4.6 percent and less than 3 percent in 1984 and 1985 (see table 2).

-- If exports are slowed by an increase in the value of the yen, the effect is delayed but eventually is as severe. Appreciation of the yen to 180 per dollar (the baseline case calls for 215 per dollar) would not affect growth significantly in 1984, but GNP would increase by only 2.9 percent in 1985. [redacted] 25X1

Most forecasters expect Japan's trade surpluses to remain at high levels for the foreseeable future and to provide some stimulus to growth for the next few years. This year's EPA white paper on the economy sees a growing role for Japan as a capital exporter as a result of chronic trade surpluses and the excess of savings above domestic investment. Forecasts by the Japan Economic Research Center, Nomura Research Institute, and others also predict continuing trade surpluses and capital exports. [redacted]

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Table 2

If Export Growth Slows
(Growth Rate of GNP in Percent)

	1984	1985
Baseline forecast	5.2%	4.1%
No growth in exports to US	4.6%	2.9%
Yen appreciation to 180 per dollar	5.2%	2.9%

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It is possible, despite these forecasts of a growing surplus, that the foreign sector has already turned the corner. Import growth is picking up as the modest domestic expansion continues, and the current account surplus has not been growing rapidly in recent months. In fact, the current account surplus declined in 1984's third quarter. Should US growth slacken, increases in the rate of growth of net exports will also slow. Import demand in the past has grown rapidly in the expansion phase of the business cycle. A combination of yen appreciation, slower growth, protectionism in major foreign markets, and growing imports would reduce the growth of net exports enough to keep them from contributing significantly to GNP growth.

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The Politics of Growth

The slow growth of the domestic sector is already a political issue. Prime Minister Nakasone's rivals within the Liberal Democratic Party (LDP) have used their own proposals for boosting economic growth to raise questions about his handling of the economy.

- -- Former EPA Director General Komoto has repeatedly called for fiscal stimulus.

- -- Kiichi Miyazawa, a potential prime minister, has advocated more public works spending to "double the nation's assets."

These traditional pump-priming measures--or others that could be devised--would be limited by the government's commitment to cutting the persistent budget deficit. Even so, they would please at least some domestic constituencies and would give the appearance of action designed to increase growth, whether or not they proved successful. 25X1

We have examined the effect of several possible measures to stimulate specific sectors of the domestic economy--more public investment, business tax cuts, sharper wage increases--under the assumption of slower export growth. In all the simulations we assume that slower growth is caused by appreciation of the yen to 180 yen per dollar. 25X1

Our simulations suggest that increased government spending would have the strongest impact on growth. If government investment were increased 10 percent beginning in the fourth quarter of 1984, GNP growth would reach 5.4 percent, compared with 2.9 percent if fiscal policy were unchanged. If total government spending (both consumption and investment) were increased by 10 percent, GNP growth would reach 5.6 and 4.7 percent in 1984 and 1985, despite the slowdown in export growth. 25X1

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Consumption and investment would be difficult to stimulate directly. Rapid wage increases might boost consumption but not by enough to offset the induced decline in net exports. According to our simulation, even a dramatic increase in wages and salaries would increase real GNP's growth rate only slightly. Inflation would also increase. A corporate tax cut has been proposed to boost the economy by stimulating investment, but in our simulation even a large cut produced only a slight effect. [redacted] 25X1

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